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SUBJECT: London Financial Experts Anxious for Conclusion of U.S.
Support Package, Pessimistic on UK Outlook

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Summary

1. (SBU) Uncertainty about the fate of the USG proposed \$700 billion support facility has paralyzed UK financial markets, senior HMT officials told Econoffs on September 25. There is no inter-bank lending at the moment, and all the big players are waiting for news about the plan before making significant market moves, Steve Pickford, Director International Finance, commented. While the Treasury is concerned about the bleak macro-economic picture in the UK and the dim prospects for a quick recovery, HMG is not planning any wide-reaching financial support package. Bankers share the same pessimistic view about the UK economy. U.S. bank representatives told econoffs on September 23 that the UK economic outlook is likely to get worse. The UK is likely to be in a technical recession by the end of the year, compounded by a severe slump in the housing market and weak public finances. Sterling will continue to fall against the dollar, stabilizing at around \$1.74 by December 2009, they predicted. The political response to the economic crisis has been inadequate, argued the bankers. A 'surreal' Labour party conference exposed a political set detached from the realities of the financial crisis. While in Brussels, EU Commissioner McCreevy is pursuing new proposals that seem as much an effort to create a personal legacy, than to address market failures, they stated. End Summary

HMT Welcomes USG Proposed Support Facility

2. (SBU) While there might be questions about various details of the U.S. facility, a flawed plan is better than no plan, argued Steven Pickford, Director International Finance, HMT. The absence of a plan would just worsen investor jitters and could create panic that would prove near impossible to mitigate. He added that unlike the U.S., the UK is not considering any wide-spread financial support package at this moment, though several short-term and intermediary steps have been taken - such as banning the short-selling of stocks until the end of January. Pickford suggested that better cooperation between U.S. and UK authorities on these measures, and more advance warning about steps under consideration, would be desirable.

Gloomy Economic Outlook Gets Gloomier

3. (SBU) The UK's economic outlook will remain gloomy through the medium-term, according to economists at JP Morgan. Negative growth of 1 percent in both Q3 and Q4 of 2008 will indicate a technical recession. Their outlook is shaped by the drag on the economy from the housing market, with prices forecast to fall by a further 10 to 25 percent by 2010. Citigroup analysts believe a total decline of 30 percent is not improbable, but it is unlikely that default rates will be as bad as 1991, during a similar housing slump. While they expect the U.S. housing market to recover in early 2009, problems in

the UK will persist because homeowners are more highly leveraged. Housing price declines are likely to be relatively uniform across the country, according to analysts at Morgan Stanley.

14. (SBU) The bankers were pessimistic about HMG's outlook of recovery by 2010. They believe the shape of the outlook will be dependent on the fiscal deficit, which will be hurt by a significant reduction in corporate tax revenue. They noted that infrastructure projects, such a Crossrail (a train line running east to west across London), will be postponed, if not cancelled, due to lack of funding.

Sterling Has Further To Fall Against The Dollar

15. (SBU) While Sterling has experienced a large correction over recent weeks, it has a little further to fall against the dollar. JP Morgan analysts expect the pound to fall to \$1.74 by the end of 2009 (from approximately \$1.855 currently). This weakening will be assisted by a likely turn in the interest rate cycle. Interest rate cuts are increasingly likely following speeches by Sir John Gieve, Deputy Governor of the Bank of England, and Kate Barker, a Member of the Bank's Monetary Policy Committee, in which they indicated that the dampening effect of the credit crisis on the economy could be bigger than anticipated - hinting that they may vote in favor of a rate cut. Morgan Stanley holds to its "smile" forecast for the GBP/USD rate. While Sterling may continue to weaken slightly, it should slowly recover by the end of 2009.

"Surreal" Labour Party Conference

16. (SBU) One banker had received feedback from the Labour party conference, held in Manchester, that the atmosphere was "surreal", with politicians and Labour delegates detached from the reality of

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the financial crisis. Another commented that the crisis has caused significant friction between Number 10 and government departments. When Number 10 introduces proposals, such as the suspension of stamp duty (a tax paid when buying property), the departments fight back, arguing that the funds are not there to support the project.

Action in Brussels, the view from London

17. (SBU) There was consensus among the bankers that Charlie McCreevy, European Commissioner for the Internal Market and Services, is taking a tough line to push through proposals for regulating Credit Rating Agencies (CRA) and revising the Capital Requirements Directive (CRD) prior to the end of his term as Commissioner. The proposals will need to be passed by the beginning of next year which, the bankers argued, will mean little consultation with business will be conducted. Parliament will also have little time to debate the proposals. One bank representative said that McCreevy has changed from a light-touch, laissez-faire liberal to more of an "interventionist" - looking to have international organizations address the causes of financial market instability. Some of the bankers argued that McCreevy is looking to create a personal legacy, by seemingly addressing the problems without giving sufficient consideration of long-term effects.

18. (SBU) The bank representatives said the Commissioner's CRD proposals are extreme and one quoted him as saying "I'm going to kill the originate to distribute model" when speaking of his proposals to require originating banks to hold 10 percent of all securities they underwrite. Another roundtable participant was critical of the proposal given that it had not been subject to the usual impact assessment procedures. One banker stated that among Member States, eleven, including Spain, France, Italy, Germany and the UK were opposed to the proposals. However, it is unclear what states will voice their opposition if the Originate to Distribute rules are only applied to Collateralized Debt Obligations and not traditional bond instruments.

19. (SBU) While Brussels is seeking to assume greater influence in

responding to the crisis, there is no unanimity on how to deal with the immediate fallout, said Pickford from HMT. Nor is there consensus about whether a new regulatory framework should be created. Member states are being affected differently, with several of the smaller countries still measuring positive growth rates. There might be one unintended result of the crisis: a fracturing of the consensus about deficit spending. While the UK has already exceeded the target the Growth Stability Pact 3 percent fiscal deficit target, Pickford ruefully admitted, other countries might use the crisis to push for a loosening of this target.

TUTTLE